

Kyrgyz Republic's Economic Prospects and Challenges¹

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The Kyrgyz Republic -- a small, mountainous country in Central Asia -- has faced major political and economic challenges since achieving its independence from the Soviet Union in 1991. In the early 1990s Kyrgyz experience an economic decline accompanied by hyperinflation and rising unemployment resulting in political crises and constitutional changes. In 1998 the Kyrgyz Republic became the first member of the Confederation of Independent States to join the World Trade Organization. Kurmanbek Bakiyev became president in 2005. Comfortably reelected in July 2009, Bakiyev appears firmly in power and may be moving his country away from a relatively democratic political system toward a more dynastic pattern. The political opposition can be expected to mount protests, but the authorities should be able to handle the dissent. The ruling elite appear to be secure and have received significant funding from Russia in the form of budgetary support and investment.

The Kyrgyz Republic is poor and has a narrow economic base. GDP per capita in purchasing power parity terms was estimated to be \$2,100 in 2009. Forty percent of the population is thought to live below the national poverty line (down from 56% in 1999). The economy is heavily agricultural and national exports are concentrated in a few commodities, notably gold, tobacco and cotton. Nearly half the labor force works in agriculture. Agriculture, hydropower and mining are all vulnerable to adverse weather conditions and natural disasters. Economic diversification would be beneficial.

The Kyrgyz Republic does have rich mineral resources, but it possesses negligible petroleum and natural gas reserves. It imports oil and gas but has substantial deposits of coal, gold, uranium, antimony and other rare-earth metals. The government hopes to attract foreign investment in mining and metallurgy, but local business conditions are very challenging for most companies.

Gold production dominates Kyrgyz industry and exports. The Kumtor gold field is one of the world's largest but is rapidly being depleted. Gold production is the largest component of the industrial sector. Fluctuations in gold prices and production have a large impact on GDP. The Jerooy gold mine is currently in search of a strategic investor. The EIU expects the price of gold to rise by 8.7% in 2010, before falling by 6.5% in 2011. If so, it will remain at historically high levels over the next two years.

GDP growth slowed from a robust 7.6% in 2008 to an estimated rate of only 1-2% in 2009; the Economist Intelligence Unit (EIU) expects the economy to grow by 3.5% in 2010 and 4% in 2011, while the World Bank foresees growth of only 2.0% in 2010. Rapid growth in 2007 and 2008 was buoyed by high international gold prices. The sharp slowdown in 2009 was primarily attributable to the recessions in Russia and Kazakhstan. The Kyrgyz Republic's non-

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gold exports go mainly to Russia and Kazakhstan and the two countries are also the primary destinations for migrant workers from the Kyrgyz Republic. Falling GDP in both countries in 2009 reduced the demand for Kyrgyz exports and cut the flow of remittance payments, which provide important support for household consumption. Revived economic growth in both Russia and Kazakhstan in 2010 can be expected to increase the demand for Kyrgyz exports and labor. Russian- and Chinese-financed construction projects in the hydropower sector will also help boost growth.

Recent economic policy has sought to limit the effects of external shocks. The Kyrgyz Republic has agreed to an 18-month arrangement under the IMF's exogenous shocks facility. However, the government can be expected to balance the goal of meeting the Fund's criteria against the aim of preventing a rise in social instability. Poverty remains widespread in the Kyrgyz Republic and many families depend heavily on remittance income. The government hopes to cut inflation, sustain economic growth and reduce poverty.

The World Bank recently praised the Kyrgyz Republic as one of the world's leading reformers of the business enabling environment. In its *Doing Business 2010*, the Bank listed the Kyrgyz Republic as one of the top ten business environment reformers, citing a number of recent reforms that catapulted its global ranking on the ease of doing business index from 80th in 2009 to 41st in 2010. These reforms, which included tax cuts and numerous administrative simplifications, brought about dramatic improvements in such important aspects of doing business as getting credit, registering property, employing workers, trading across borders, starting a business and obtaining construction permits.

Yet although the government does appear to be committed to creating a market economy, important impediments to private enterprise remain. The EIU says that "a combination of political divisions within the country, social concerns and vested interests is likely to continue to impede progress on implementing the structural reform agenda. The authorities have pledged to make FDI a priority. However, uncertainty remains regarding the government's ability to implement such policies, as domestic opposition to the sale of state assets is strong, and foreign investors will remain wary because of the poor business environment and high levels of corruption." Recurrent power shortages are an additional impediment to investment in the Kyrgyz Republic.

Because of these cautionary factors, FDI in the Kyrgyz Republic in the near term is likely to come mainly from investors who are familiar with the business environment in Central Asia, especially companies from Russia and Kazakhstan. The Kyrgyz Republic's long-standing links with these two countries means that objections to their increased role in the Kyrgyz economy are unlikely to arise. Yet the current economic weakness of both those countries means that investment from those sources is also likely to be limited.

The government budget apparently ran a deficit in 2009, but fiscal balance is likely to be restored in 2010, thanks in large part to budgetary support from Russia, the World Bank and the IMF. Previously, the government had had severe fiscal problems and ran large deficits. A new tax code, introduced at the beginning of 2009, cut the value added tax rate from 20% to 12% and also reduced tax rates on small business. These tax rate reductions, combined with the

sluggish economy, reduced government revenues. Meanwhile, the government increased expenditure on wages and pensions, partly as a way of forestalling political dissent. The government estimates that the general government budget (a broader measure than the state budget that includes budgetary funding of the Social Fund) ran a deficit equivalent to 1.3% of GDP in 2009. The EIU expects that a pick-up in real GDP growth will enable the government to bring the budget back to approximate balance in 2010 and 2011.

The Kyrgyz Republic is receiving strong financial support from the Russian Federation.

The government has stated that it will use the \$300 million Russian budget support loan to finance infrastructure construction and lending to small and medium enterprises through a newly established development fund. In addition, Russia will provide a \$1.7 billion loan on concessional terms for a hydropower project and an additional \$94 million in a debt-for-equity swap.

The current account of the balance of payments was roughly in balance in 2009 but can be expected to return to a deficit in 2010 and 2011. Although exports and remittance inflows declined, the cost of imports also fell sharply during 2009. This caused the trade deficit to narrow compared to 2008. Over the next two years, exports and imports are both expected to rise, but the EIU expects imports to rise faster, creating a current account deficit of 3.4% of GDP by 2011.

The national currency, the som, depreciated sharply in late 2008 and early 2009 but later stabilized. The som fell by 21% against the US dollar in the year to end-August 2009. From April on, however, the pace of depreciation slowed as the central bank spent heavily to support the som. This depleted foreign exchange reserves, which were replenished later in the year through foreign support. The National Bank of the Kyrgyz Republic (the central bank) appears to be pursuing a policy of occasional intervention in currency markets aimed at permitting smooth and gradual depreciation of the som in order to boost export competitiveness. The EIU expects the Kyrgyz currency to depreciate to Som46.4:\$1 by the end of 2010 and to Som47.2:\$1 by the end of 2011. Disbursements from the IMF and funding inflows from Russia will obviate the need for a sharper devaluation, as will lower debt payments as the external debt falls owing to the renegotiation of Paris Club debt. The government has resolved to tap only concessional sources of credit in the future.

Inflation, which had been high in 2008, moderated in 2009. Soaring world oil, commodity and food prices pushed the rate of inflation to 24.5% in 2008, but a fall in these prices permitted it to drop back to an estimated 7.1% last year. World commodity prices are expected to rise again in 2010 and 2011, lending impetus to consumer price inflation in the Kyrgyz Republic. Revival of consumer demand as remittance receipts recover in 2010 will boost demand for locally produced goods and services. Utility prices are also likely to rise as the government tries to move toward cost-recovery in the electricity sector. The EIU predicts that inflation will run at 9.3% in 2010 and 10.5% in 2011; the World Bank predicts rates of 7.5% and 9.0% respectively. Continued devaluation of the som would also contribute to inflationary pressures.

To foster credit growth and encourage commercial banks to finance economic development, the central bank cut its discount rate three times in 2009, reaching an historic

low of 2.38% at the end of October. The action succeeded in raising the volume of commercial bank lending.

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